


**CITY OF SAN DIEGO
M E M O R A N D U M**

DATE: September 17, 2007

TO: Councilmember Donna Frye 

FROM: Jay M. Goldstone, Chief Financial Officer / Interim Chief Operating Officer

SUBJECT: Response to Questions Regarding IRS Code Section 415

Attached you will find a response to the specific questions you raised regarding IRS Code Section 415. As you consider these responses, please note that many of the questions presented concern issues of tax law. My responses are based upon what I know at this point and to that extent I have provided my understanding of the various issues as they relate to the financial implications of this issue to the city. I am not an attorney, however, and would encourage you to further consult the Office of the City Attorney concerning matters involving interpretations of federal tax law.

- 1. Please provide a copy of the relevant IRS Code Section(s) and an explanation for the intent of that those code Section(s).**

I have attached a copy of IRS Code Section 415 ("Section 415") to this memorandum.

My understanding of Section 415 is that it provides limits on benefits and contributions and other additions under qualified retirement plans. The purpose behind Section 415 is to limit the extent to which benefits and contributions can receive the favorable tax treatment provided to a qualified retirement plan.

- 2. Please describe this "Compliance Strategy" in detail. Please specifically address the following questions in your description:**

Copies of the "415(b), (c) and (n) Compliance Report Strategy Report" and the "415(m) Compliance Strategy Report" SDCERS filed with the IRS are attached to this memorandum.

The first report discusses the limits imposed by Section 415 in great detail, including how those limits apply to SDCERS. The second report discusses Section 415(m) and the POB Plan establish by San Diego Municipal Code ("SDMC") Section 24.1603.

- a. **It appears that this "Compliance Strategy" assumes the \$22.8 million unfunded liability no longer exists as a SDCERS pension benefit and therefore removes it from the SDCERS financial and actuarial statements, but at the same time the City intends to continue to recognize it as a pension benefit and pay for it. Is that a correct description? If not, please explain why not?**

By adopting SDMC Section 24.1603, the City Council confirmed its intention to honor the City's pension obligations regardless of the 415 Dollar Limit. The City's POB Plan provides that the difference between the pension benefit that would otherwise be payable to a member but for the 415 Dollar Limit, and the pension benefit as capped under Section 415(b), will be paid from the POB Plan. Therefore, the City will pay pension benefits in excess of the 415 Dollar Limit from the POB Plan to SDCERS who will in turn provide this benefit to Retirees.

There is currently no clear accounting guidance on accounting for Qualified Excess Benefit Arrangements. To remediate this, we have contacted the Governmental Accounting Standards Board (GASB), and they have responded indicating that they may have no position on the matter. However, discussions with the GASB will continue.

It is the preliminary position of the City Comptroller that both SDCERS and the City should treat the Qualified Excess Benefit Arrangement (QEBA) as a defined benefit plan separate from the City and SDCERS qualified pension trust.

The Comptroller's accounting position involves the discrete reporting and separate valuation of the 415 plan by SDCERS actuary. If the City were to adopt this type of presentation, the result would be the accrual of a liability (NPO) on the City's financial statements for the difference between the Actuarially Required Contributions to the plan and the annual "pay as you go" expenses of the plan. When the plan is terminated, because no employees are exceeding the IRS limits, the NPO would be removed from the City's financial statements at such time the plan terminates because no retirees are violating the IRS limits.

- b. **Currently the City and some of its employees are making pension contributions for future pension payments that apparently exceed IRS 415 legal limits. Those contributions are being invested in SDCERS which is a tax deferred 401(a) trust account. Does this IRS Compliance Strategy include the use of another tax deferred account?**

No. Code Section 415(b) limits the benefits payable from a qualified pension plan, not the contributions received by the plan.

As provided in SDMC Section 24.1606, and required by federal tax law, the POB Plan will be funded entirely by the City on an annual basis. No employee contribution or deferrals will be allowed into the POB Plan.

c. Will this other account also be a 401(a) Trust?

No. The POB is a 415(m) Trust.

d. Are the contributions for pension benefits that exceed the IRS 415 limits going to be deposited into this other tax deferred account?

No, this is not allowable under federal tax law or SDMC Section 24.1606.

e. Has the IRS agreed that the City and its employees may continue to make contributions to pay for benefits that exceed the 415 limits by simply depositing those assets into this other tax deferred account thereby just shifting the assets and liability for the SDCERS pension account to this additional tax deferred account?

No, this is not how the POB Plan operates. SDCERS 401(a) plan and the POB Plan are independently funded and contributions will never be transferred between the two. Pursuant to tax law and SDMC Section 24.1606(e), the City assets used to provide benefits under the POB Plan "may not be commingled with the monies of any other Plan in the Retirement System, or any other qualified plans, nor may this Plan ever receive any transfer of assets from the Trust Fund established for any other plan in the Retirement System."

f. How many defined benefit employee pension plans may the City of San Diego legally have?

There is no legal limit on the number of defined benefit plans the City can establish.

g. Will we receive an Annual Actuarial Valuation for this additional pension plan? Who will prepare that valuation? Please provide the supporting actuarial schedule that forecasts the growth of this estimated \$22.8 million unfunded liability and corresponding annual required contributions over the 20 year fixed amortization period using the EAN methodology and please

disclose the other actuarial assumptions used in the schedule (i.e. 8% discount rate, 4.25% salary inflation, etc.).

Because the City will need to contribute the projected amount necessary and pay the pension benefits due from the POB Plan during that calendar year, no separate Annual Actuarial Valuation will be prepared for the POB Plan. That projected amount will be determined by SDCERS' actuary in accordance with procedures approved by the IRS.

h. Will SDCERS administer this plan?

Yes. When the City Council adopted SDMC Section 24.1605, it provided that "administration of the Plan shall be under the exclusive management and control of the [SDCERS] Board.

i. Will the annual required contribution to fund this \$22.8 million unfunded liability be subject to GASB disclosure requirements? If so, which GASB Statements?

There is no GASB guidance specifically designed to address QEBA's. If this is determined to be a defined benefit plan, it will be reported accordingly and if it is not, then it will be reported as a defined contribution plan expense on the City's financial statements.

3. Who made the decision to use this "Compliance Strategy"? Please provide any and all documentation relating to it.

The City Council adopted Ordinance 0-18930 on March 19, 2001, establishing the POB Plan to pay promised pension benefits above the 415 Dollar Limit. This was the first step in implementing this compliance strategy.

4. Has the IRS approved of this "Compliance Strategy"? If so, please provide documentation from the IRS that states they have approved this "Compliance Strategy."

Congress created QEBAs for the purpose of paying benefits above the 415 Dollar Limit. The City Council chose to use this compliance option when it adopted the POB Plan.

SDCERS filed a private letter ruling request with the IRS with respect to the POB Plan, in order to ensure that it meets all of the statutory and regulatory requirements applicable to a QEBA. That request is pending.

5. When did you first become aware of these IRS 415 violations?

I personally was not aware of this issue until SDCERS issued its June 30, 2006 Actuarial Valuation in January 2007 and even then did not fully appreciate the issue until further discussions with SDCERS. It is my understanding that the current management of SDCERS first became aware of the IRC 415(b) violation in 2005. As a result, SDCERS filed a supplemental voluntary submission to the IRS in August 2006 which included issues relating to Code Section 415(b). However, it should be noted that the necessary changes to the municipal code to codify the QEBA were made in 2001, this suggests that members of past city management were aware of this issue.

6. Did you make KPMG aware of this issue? If so, when?

KPMG was provided all available documentation concerning the Voluntary Compliance Filing directly by SDCERS. The City Comptroller does recall reviewing the documentation with KPMG and discussing various issues related to the Voluntary Compliance filing during the December 2006 to February 2007 timeframe.

7. Has this issue, the corresponding unfunded liability and annual required contributions been properly disclosed in the 2003 CAFR? If so, on what page?

During the period reported in the 2003 CAFR and for previous periods, the QEBA plan was included in the City's Actuarial Liabilities for the City's 401A plan. This means that the \$22.8 million was not excluded from the City's Annually Required Contribution and as such, the plan was fully expensed in the same manner as it would be under the City Comptroller's proposed accounting treatment. The result is that this has the same impact on the City's ending Net Assets for the period reported as if the QEBA was reported as a discrete defined benefit plan.

The City's financial statements were and still are, deemed to be reasonable and considered to be materially correct. Furthermore, the City's actuarially determined liabilities were correct in total. However, certain other disclosures required by GASB 27 were not included in the City's 2003 CAFR. These disclosures include discretely presenting the funding progress of the plan, the description of the plan and certain other actuarial information concerning the QEBA plan.

Considered from a quantitative perspective, the QEBA plan, valued as of June 30, 2006 constitutes .7% and .6% of fiduciary net assets held in trust by SDCERS and total Actuarial Accrued Liability respectively. Using 1% (which is considered low by most

professionals) as a basis for evaluating quantitative materiality to the financial statements, both indicators fall well below the acceptable range. As such, we are comfortable with the presentation of the 2003 CAFR.

It should be noted that staff has added a narrative discussion of the QEBA plan into the 2004 CAFR on page 105 of the CAFR.

- 8. Has this issue, the corresponding unfunded liability and annual contributions been properly disclosed in the SDCERS 2003 and 2004 CAFRs?**

The retrospective testing failures of benefits actually paid in excess of annual 415(b) limits were disclosed in SDCERS' fiscal year 2004 CAFR. It was not included in the SDCERS fiscal year 2003 CAFR. The impact to the City's Unfunded Actuarial Liability was disclosed in the City's June 30, 2006 Annual Actuarial Valuation. SDCERS has received an unqualified opinion on their 2004 CAFR.

- 9. Who calculated the \$22.8 million unfunded liability number? Have you confirmed that number with the City's actuary? If not, do you intend to?**

SDCERS' actuary, Cheiron, calculated the impact of applying Section 415(b) limits to its calculations of the overall plan liabilities in the City's June 30, 2006 Annual Actuarial Valuation Report.

- 10. Since this \$22.8 million unfunded liability results from defined benefit pension promises that are outside the proper treatment of IRS 415 limitations how is it legal for the City of San Diego to simply assume that unfunded liability from SDCERS?**

I will defer to the City Attorney for an answer to this question.

- 11. Is this IRS 415 limit violation strictly created by the defined benefit pension payments or do the payments from the DROP accounts also contribute to the IRS 415 limit violation?**

A member's DROP benefit must be included in the 415(b) limit testing, which increases the number of payees who exceed the 415(b) limits, as well as the amount by which they exceed the limits.

- 12. How many employees are currently receiving pension benefits above what the IRS considers legal and/or are outside of benefit limitations? What is the average amount of benefits that are received per employee above the IRS limitations?**

After the IRS approves SDCERS' testing methodology, SDCERS will know the affected number of members and the exact amounts involved.

- 13. Will this liability grow as more employees are added or have corrective actions been taken to prevent this from continuing? Is there any action(s) that the City Council should take to correct this?**

Whether any one individual's pension benefit will exceed the 415 Dollar Limit at retirement depends upon the actual Section 415(b) limits as set by Congress and adjusted by the IRS, and a variety of actuarial probabilities, such as how long the employee will work for the City, the probability of earning a vested benefit, the employee's age at retirement, the employee's pensionable compensation, how fast that compensation increases over the course of a career, the amount in the member's DROP account at retirement, and whether and how the benefit structure changes with respect to that employee.

The City Council took corrective action to eliminate Section 415(b) violations, while permitting payment of its promised benefits, by establishing the POB Plan.

- 14. What is the dollar amount the City proposes to pay towards this unfunded liability in the 2008 budget? Where is the Annual Actuarial Valuation that supports that annual contribution amount?**

The City will not make any payment toward the "unfunded liability" for the excess benefits to be paid from the POB Plan. Instead, the City will pay into the POB Plan, on an annual basis, the amount necessary to pay that year's benefits above the 415 Dollar Limit. As explained above, the POB Plan cannot be pre-funded.

Each year SDCERS will determine the amount necessary to fund any pension benefits payable during that year in excess of the Section 415(b) limits. This amount will include the projected amount of all excess benefits payable for the calendar year to existing and projected payees, as well as the projected cost of administering the POB Plan.

SDCERS will provide information to the City and the City will fund this amount on an annual basis. Any amounts remaining in the POB Plan at the end of a calendar year will be carried forward to pay benefits and administrative costs in the following year.

- 15. On what page of the proposed 2008 budget is that annual required contribution for this unfunded liability shown? (I believe that you referred me to page 133 of**

Volume II, but I cannot locate it.) Is the \$22.8 million unfunded liability shown in the the budget or just the annual payment?

The projected payment to SDCERS for this liability has been budgeted in Citywide Program Expenditures and is on page 133 of Volume II of the proposed Fiscal Year 2008 Budget. It was not specifically called out in the budget document but rather is part of the \$2,874,735.

With respect to the budget, we have budgeted payment of this liability on a pay as you go basis which is consistent with IRS requirements. As such, SDCERS has estimated the payment to be approximately \$500,000. The City will ultimately pay the actual amount billed by SDCERS.

- 16. Is there any other information of which you are aware that is material that I have not asked you?**

None that I can think of.

Attachments

Cc: Honorable Mayor Sanders
Honorable City Council Members
Honorable City Attorney
Independent Budget Analyst
SDCERS Administrator